I discussed in Chapter 1 how standard economic theory sets out to demonstrate how markets can work. The basic thrust of the argument is that unfettered self-seeking competitive behaviour coordinates an economy and achieves optimal wealth creation and welfare. Markets are self-equilibrating so that inhibiting the behaviour of those in them or interfering with them in any other way than to encourage competition can only produce suboptimal outcomes.

The standard economics story is a very old and specific one. It played a key ideological role in the development of English and American capitalism and emerged from philosophical debate following Hobbes and Locke as to the origin of social order and the divine right of kings. Its roots are in a developing opposition to the monopolies and tariffs imposed by Stuart kings during the English revolution and then by later English governments on their American colonists and then still later in the English nineteenth-century struggle between the landed and manufacturing classes over tariffs. The efficient market hypothesis invokes reason to argue ‘freedom’ from political control. To justify this political position it aims to demonstrate that far from helping a society to achieve wealth, cooperation, and coordination, monarchies and governments inhibit the working of the ‘invisible hand’.

We could say that the classical theory wobbled a bit during the Great Depression. Keynes and the economics of uncertainty had its day for a while. But quite quickly thereafter, in the second half of the twentieth century, its essence was forgotten. A modernised and sophisticated mathematical version of the classical approach re-emerged in the United States which paid no real attention to uncertainty or instability and, drawing on doubts about Keynesian macroeconomic policy due to growing problems with price inflation, returned to discussing how markets should work. A major consequence of this neoclassical theory, accelerated in the last 30 years, is that it legitimated deregulation, free market ideology, and globalisation without trade barriers just as two and
three centuries earlier its ideological manifestation had legitimated an end to royal monopolies and barriers to free trade.

A central question that might be used to judge any theory is to ask what it is for. Theories designed to show how markets produce an efficient equilibrium must struggle when asked why they sometimes do not. The only answer available from within the paradigm is that governments and institutions have interfered – markets aren’t being allowed to work as they could. Although different at first sight, both information economics and behavioural economics can be kept within the same paradigm. In essence what they both do is show up potential interferences that need attention if things are to work – they can then be used to support measures such as transparent contracting to resolve agency issues, derivative or virtual market creation to complete markets, or behavioural finance investment strategies to ‘clean up’ the anomalies caused by investor biases. The last proposal is particularly popular among some finance professionals because it gives them a role, which efficient market theories do not. In any case none of these theories from within the central paradigm really has any rigorous explanation for financial instability.

This chapter aims to set out a framework to understand the minimum requirements for a new economic theory of financial markets directly aimed at understanding their empirical reality and how it can lead to persistent instability – as is now much more widely accepted to be a risk than it was five years ago. As I showed in Chapter 1 severe bouts of instability are nearly always associated with the arrival of new, exciting products and then subsequent dislocations in risk-reward relationships.

My ideas about phantastic objects, narratives, and states of mind were built up as I struggled to understand empirical reality while in a to-and-fro process of collecting data and thinking about it. They emerged as I did the interviews and thought about them as what sociologists call ‘grounded theory’ (Glaser and Strauss 1967; Brown 1973). I have mentioned, for example, how in my very first pilot interview it became evident that the simplified model of rational decision-making used in standard theory just didn’t seem to apply to what my respondent was trying to do. He could calculate as much as he liked but he was still left with uncertainty and several equally attractive alternatives from which he selected by touch and feel. The world of the four asset managers described in Chapter 2 elaborated this first impression about uncertainty and revealed three further emerging themes. My respondents seemed to be talking about making and breaking emotional attachments to stocks. They seemed to be strongly influenced by, and oriented towards, their feelings within a social and institutional context. And they dealt with all this by telling stories. These first four interviews had made clear the decision context (what Talcott Parsons (1937) called the conditions for social action) and in doing so demonstrated the very limited utility of economic rationality as a significant guide to behaviour.